



Why do we own stocks?

Most would say to earn money, and at its core that answer is correct. But how does owning stocks make us money? Stock investing represents a fractional share of ownership in a company's growth potential. When we buy a stock as an investment, we now possess a small piece of that company's business and we share in the ownership of its revenues and profit through appreciation of its stock price and, in some cases, the distribution of its free cash flow in the form of a dividend.

The price of that stock is set via an auction, through a bid and an ask price, and these transactions are done daily on the stock exchanges. The more buyers that want to own a piece of that company's future growth, and the fewer sellers looking to exit, the price will rise as the bids outstrip the amount being sold. In reverse, when there are more investors looking to sell than to buy the price declines.

While this sounds simple in concept there are many factors that impact the demand for that company ownership. What is the outlook for the company's growth? What is the outlook for the industry it is in? What is the outlook for the sector its part of? And what is the outlook for the general economy? All these things tie into how investors value the stock that they are looking to buy or to sell.

And that is where the math comes in.

One of the most widely used metrics of valuation is the price to earnings ratio or PE ratio. The PE represents the multiple of earnings that investors are paying to own that stock. As an example, if a company earned a \$1.00 a share of earnings and its stock price were \$15 a share then we would say that the stock was selling at fifteen times its earnings or had a PE of 15x. To think of it another way, if we bought the whole company our expectation would be that in 15 years, we would make all our money back through the profit earned each year.

Why is this important? Having worked as a financial advisor for thirty years there is a mantra that I learned not to pay heed to and that is "this time it's different." Through three decades of bull markets, bear markets, booming economies, recessions, Great Recessions, financial crises, tech bubbles, pandemics, low interest rates, high interest rates, no inflation and higher inflation, there has always been a core of math to the markets that holds true. Sometimes we get ahead of that math, and we start hearing "those metrics no longer are relevant" and sometimes we decline too much because we panic and forget to pay attention to our fundamentals. Yet, it is during both periods, times of frothy euphoria and times of nervous decline, that we need to stay focused on them.

Historically the S&P 500, which is a comprehensive, market capitalization weighted index of five hundred of the largest US companies, spread across most sectors and industries, typically sells between 12x-18x its aggregate earnings. This PE range can be traced back to the S&P Index's creation in 1925.

As we entered 2022, the expectation for full year earnings on the S&P 500 was an aggregate \$228 a share and the index stood at 4,766. That represented a PE of 20.90x, which was almost three multiples higher than long term norms. That did not mean that the market was due for a decline, but when we are priced at higher multiples investors must feel confident that higher than expected earnings growth will continue not just for that year but also for the foreseeable future.

At that time, there was no war yet in Ukraine, inflation was increasing but the Fed was still discussing it being "transitory", the Fed had not yet announced a tapering of their quantitative easing (where they buy Treasuries on the open market to pump more cash into the system), interest rates remained low, employment was up, and COVID was beginning to ease.

Fast forward four months and war had broken out in Ukraine, which adversely impacted commodity prices, inflation became hotter driven by a combination of rising wages, higher commodity prices and continuing supply chain issues exacerbated by China's Zero COVID policy, the Fed gave clear indication that their days of buying Treasuries was over and that instead they would begin to sell bonds off their balance sheet back into the open market, and that they would need to raise interest rates to slow economic growth and tame inflation.

At that point investors began to pay attention to the math again.

First, they questioned if paying a 20x multiple of projected S&P earnings, in the face of a purposely slowing economy, was reasonable and then began to question if \$228 a share of earnings on the S&P 500 was still expected given higher costs of labor, commodities, and a global supply chain that still was not functioning properly. All of which has led to a repricing of expectations.

Currently, as I write this, the S&P 500 sits at 3991. Using the previous \$228 a share of S&P 500 earnings expectations, the market is currently selling at a 17.5x multiple, and while still on the high end represents a more properly priced market than when we started the year. A few weeks ago, Goldman Sachs restated their expectations for 2022 to be \$221 a share, down from the \$228. They were the first to reduce, and to date we have not read or heard on any conference calls, anyone else reducing. That level would put us at an 18x multiple.

It is our belief that the Ukraine War will influence 2022 S&P 500 earnings. Between the number of S&P 500 companies that have pulled business lines out of Russia, to the war keeping the price of oil, natural gas, and by extension gasoline, artificially higher, as well as higher interest rates making it more expensive for companies to access capital, we believe that Goldman's forecast more accurately reflects expectations.

It is our feeling that the selling pressure we are currently experiencing will remain a bit longer but that we are in the process of finding our footing. We may very well overshoot where we should be before stopping, as the markets tend to overreact both in good times and bad, but the froth of the cheap liquidity exuberance has been removed and we are more reasonably priced than before.

Likewise, this is not a fundamental breakdown of the financial system, like in 2008, or an S&P 500 that was selling at 33x earnings, like prior to the Tech Bubble of 2000, and thus had to shed a lot of excess. Instead, we remain confident in the thesis that this was a market that had gotten ahead of itself based on the easy monetary policy reaction to COVID and is one that is now pricing in slower growth for 2022 and 2023. But with the NASDAQ in bear market territory, defined as more than a 20 % drop, and the S&P down almost 17 % from its peak, and an index selling at more normal PE multiples, we believe we are slowly finding our way back to the math that tells us we are properly priced.

Recognizing that these periods can be very disconcerting, the Team and I are here to answer any questions or concerns you have about the volatility, the economy, our outlook and how it all ties into your planning and investment management. Just reach out if you want to walk through it all and we'll get on a call or videoconference and discuss everything together.

Take Care,

Steve